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Poland: Failure To Adjust to the Financial Crisis

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An Intelligence Assessment

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An Intelligence Assessment

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Poland: Failure To Adjust to the Financial Crisis

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Key Judgments

Information available as of 16 April 1984 was used in this report.

During the last two years, the regime of Premier Wojciech Jaruzelski has made only modest attempts to adjust the economy to its financial crisis. Warsaw has not yet stabilized the growth of its hard currency debt, inflationary pressures have remained strong, and there has been little economic reform. Jaruzelski has avoided draconian measures, largely, we believe, out of concern for maintaining control over a disgruntled populace and a desire to have martial law considered a success. Warsaw has taken advantage of generous debt rescheduling terms from private banks and the de facto moratorium granted by Western governments who have refused to conduct debt rescheduling talks.

The regime, however, was able over the last two years to stem the decline in national income, run small trade surpluses, and cut consumption for the first time:
- The economic fall that continued through 1982 was reversed last year when national income grew by 5 percent.
- In 1982 the regime cut investment and hard currency imports by about 12 percent and 30 percent respectively, and, through major price increases, reduced real wages by about 25 percent.
- In 1983, however, Warsaw allowed investment and hard currency imports to rise while real wages were permitted to increase slightly—together with the supply of food and consumer goods—in an effort to win worker support.

The Poles hope to avoid rigorous adjustment measures over the next several years. Warsaw intends to pay only 15 to 25 percent of its financial obligations each year; it apparently calculates that Western creditors will agree to its terms for rescheduling the balance and not declare it in default. Warsaw hopes to maintain creditor good will by continuing to run small trade surpluses, and to secure new Western credits through rescheduling negotiations and membership in the International Monetary Fund. Meanwhile, the government wants to sustain the modest economic rebound, allowing national income, industrial production, and consumption all to grow slightly over the next two years.

Warsaw's domestic plans are unrealistic because the economy continues to be plagued by mismanagement, inefficient use of raw materials and labor, and a poorly motivated work force. As long as the government balks at cutting domestic consumption further and does not implement fully the reforms needed to invigorate production, the economy is unlikely to generate the exports needed to improve its payments position.

If the Poles continue to pay only a small portion of their financial obligations, their debt would continue to grow. Over the next two years, for example, the cumulation of unpaid interest—even without new lending—will cause the debt to increase by about $6 billion to about $32 billion at yearend 1985. This lack of decisive action to adjust to financial constraints will delay putting the country back on a firm economic footing, provide the Polish consumer only marginal gains, and, most importantly, will not secure the political stability Jaruzelski is trying to buy.

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By the end of 1980, a decade of expansionism—financed mostly by Western credits—had combined with poor management and systemic problems to leave Poland insolvent. Net hard currency debt had increased to $25 billion—five times as high as at the end of 1974—and annual debt service payments of $8 billion were about equal to the value of hard currency exports. Sources of credit were drying up as Western creditors realized that Warsaw was seeking new loans primarily to service old ones and that stabilization measures were halfhearted. Finally unable to meet its payments, Warsaw declared a moratorium on debt service payments in March 1981. This paper describes the causes of Poland's debt crisis and analyzes Warsaw's efforts to deal with it, the impact on the economy, and the adjustment policies likely over the next several years.

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What Went Wrong?

Poland's financial problems have their roots in an overly ambitious growth strategy, poor economic management, the inherent shortcomings of a highly centralized economy, and the regime's unwillingness to implement stabilization measures promptly. While the Jaruzelski regime has taken some steps to cure the country's economic ills, many of the underlying problems inherited from the 1970s prolong the debt crisis.

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A major reason for the rapid buildup in Poland's debt was the overexpansionary bias of Gierek's economic policy. With political gains in mind, Gierek sought to modernize the country's industrial base while increasing the standard of living. An investment boom was supported by heavy reliance on imports of Western goods and technology financed on credit (see figure 1). The regime boosted the standard of living (see table 1) by increasing workers' incomes sharply while allowing only minimal increases in retail prices. Per capita consumption of most major foodstuffs rose significantly, but the regime had to become a net agricultural importer to satisfy rising consumer demand.

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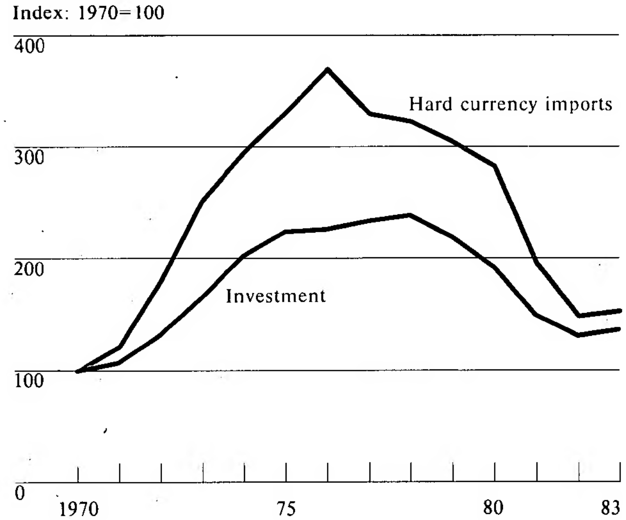
Figure 1
Poland: Relationship Between Investment and Hard Currency Imports, 1970-83



Source: Official Polish data, constant prices.

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Mismanagement and systemic problems compounded Poland's economic troubles. Warsaw's planners often failed to adequately consider the economic feasibility—particularly the export potential—of proposed new lines of production and made decisions on political grounds. Moreover, Western imports were not used optimally because the unrealistic price system understated their costs and there were few penalties for the misuse of investment capital. Enterprises also lacked incentives to produce quality goods for export since their performance was judged largely on quantity. Firms also could count on government subsidies at year's end if they encountered problems.

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Table 1
Poland: Consumption Indicators

	1966-70	1971-75	1976-80	1980	1981	1982	1983 [a]
Average annual rate of change							
Nominal income	3.7	9.8	8.8	13.5	27.4	50.7	25.0
Retail prices	1.3	2.4	6.8	9.1	24.4	101.5	23.0
Real wages	2.1	7.2	1.9	4.0	2.4	−24.7	1.6
Sales of goods in the socialized market (constant prices)							
Food	5.7	9.4	3.4	−0.2	−9.4	−13.1	−1.0
Consumer goods	6.5	10.9	3.7	2.0	6.8	−24.3	14.0
	1965	1970	1975	1980	1981	1982	1983
Per capita consumption							
Meat (*kilograms*)	49.2	53.0	70.3	74.0	65.0	58.5	56.0
Milk (*liters*)	233	262	264	262	257	255	250
Eggs (*units*)	162	186	209	223	227	200	190
Cereals (*kilograms*)	141	131	120	127	121	124	126

[a] Estimated.

Source: Official Polish data.

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Warsaw was slow to remedy its growing debt burden largely because the Gierek regime was reluctant to admit that there were serious flaws in its economic policies and feared that an austerity program would cause serious unrest. Warsaw put off painful measures by continuing to borrow heavily in the West. Between 1976 and 1980, Warsaw merely tried to slow the rise in the external deficit by reducing the rate of growth in investment and cutting imports modestly without restraining consumer demand. As a result, inflationary pressures intensified and annual trade deficits stayed at well over $1 billion throughout the last half of the decade (see table 2).

By 1980—when Western creditors began to cut back after Warsaw had missed some debt repayments—the Gierek regime decided to raise food prices moderately. The resulting strikes and demonstrations led to the rise of the independent trade union Solidarity and Gierek's downfall. His successor, Stanislaw Kania, introduced a limited, hastily conceived stabilization program in 1981, but, partly because of opposition from Solidarity, he continued to avoid consumer austerity measures. Kania slashed investments by about 23 percent and cut hard currency imports by 35 percent. Some progress also was made in substituting CEMA and domestic inputs for hard currency imports.[1] The impact of these measures, however, was undermined by others aimed at placating angry workers, including cutting working hours, holding the line on price rises while caving in to workers' demands for higher wages, and boosting imports of agricultural goods. Although Kania's policies produced a $1 billion improvement in Poland's hard currency trade position

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[1] According to recent unpublished CIA analysis, Western imports would have had to be 7 percent greater in 1980 and 14 percent more in 1981 to achieve the same output without these substitution effects.

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Table 2
Poland: Hard Currency Trade

	1970	1976	1977	1978	1979	1980	1981	1982	Estimated 1983
Hard currency trade [a] (*billion US $*)									
Balance	0.15	−2.94	−2.19	−1.91	−1.69	−0.98	0.02	1.45	1.56
Exports	1.28	4.44	4.88	5.48	6.35	7.51	5.45	5.21	5.67
Imports	1.13	7.38	7.07	7.39	8.04	8.49	5.43	3.76	4.11

[a] Official Polish customs data, current prices.

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in 1981, they also contributed to a 13-percent decline in industrial production and a 5-percent fall in GNP. Since hard currency exports declined over 25 percent, Poland achieved only a small hard currency surplus, not nearly enough to cover its debt service obligations. [redacted]

Adjustments Under Martial Law

After martial law was imposed in December 1981, the regime's major economic priority was to stop the slide in output. Warsaw quickly imposed tight controls on labor and resource allocation and passed some reform measures to encourage efficiency (see box). At the same time, the Jaruzelski regime, taking advantage of martial law controls, imposed austerity measures to show it was not neglecting its debt obligations and to boost creditor good will. (See table 3 for a summary of economic adjustment measures and their impact.) As a result of these measures, the regime was able to stop the decline in GNP, to make some progress—at least in 1982—in bringing consumer demand into better balance with available goods, and to run small hard currency trade surpluses. [redacted]

But by 1983, Jaruzelski—worried about the political consequences of continued austerity—sought to ease the burden of adjustment. Warsaw allowed increases in investment and real incomes and was unable to make significant gains in foreign trade. As a result of Jaruzelski's political concerns and waffling on austerity measures, Poland stopped far short of taking the steps necessary to cover all of its external financial obligations. Warsaw presumably calculated that it could take advantage of favorable rescheduling terms granted by private banks and the de facto moratorium extended by Western governments to divert resources to the domestic economy from debt repayments. [redacted] 25X1

Stabilization of Production. To cope with the problem of reduced inputs, in December 1981 the martial law regime imposed tight controls on labor and on physical flows of resources to check the decline in industrial production, labor productivity, and exports. The government militarized coal mining and other important industries and appointed military commissars to run more than 200 large factories. The central authorities established 14 "operational programs"—and subsequently a government contract system—that eventually controlled over half of industrial output. Central planners were given new powers to set most factory production targets on a quarterly or even monthly basis. The regime also reinstituted the traditional longer workweek, established harsh penalties for absenteeism and strikes, and restricted worker transfers. The mining industry was given priority, largely out of a calculation that its performance would be a key to reviving industrial production and increasing exports and that its output could be increased without reliance on Western imports. [redacted]

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Reform

While imposing new central controls over the economy, the martial law regime also adopted an economic reform program designed to encourage enterprise initiative and to expand the use of financial instruments—such as interest rates and bank credits—in place of administrative controls. Firms were given increased authority to set wages and prices, to make decisions on investments and product lines, and to retain hard currency earned from exports. The government consolidated several ministries, reduced central staffs, and allowed enterprises a larger role in setting their own plans. Banks received increased power to extend credits and to declare enterprises in default. [redacted]

The regime's halfhearted implementation of reform, however, often did little more than cause new disruptions. Enterprises that took advantage of some reform provisions frequently raised prices, wages, and investment much more than planners had projected. Under the reform plan, competition and profitability criteria would have limited such increases. Although the regime subsequently put some restrictions on price increases, it did not tighten wage and investment regulations. Reform measures also did not induce enterprises to use labor and other inputs more efficiently. According to the Polish press, many enterprises failed to reduce excessive manpower and material use because these costs continued to be added to product prices. [redacted] 25X1 25X1

Other measures were taken to ensure more efficient use of available domestic resources. A conservation program initiated in early 1982 sought to cut waste of raw materials, energy, and agricultural products. The central planners counted on the savings from this program to provide as much as 50 percent of industrial growth by 1983. When labor shortages became a problem—because of a surge of retirements under an early retirement program adopted in late 1981—the regime began trying to lure retired workers back into the factories with financial inducements. [redacted]

As a result of these measures, and because output of the mining sector was unaffected by the drastic drop in Western imports, the decline in GNP was halted and industrial production was stabilized in 1982-83, albeit at low levels (see figures 2 and 3). Production of traditional hard currency exports from the extractive industries—such as coal, copper, and silver—increased in 1982 by up to 16 percent over 1981, and then leveled off in 1983. Manufacturing output fell 3 percent in 1982, mainly as a result of shortages of labor and Western inputs, and then grew 7 percent last year, largely, we believe, because of increased hard currency imports and increased working time. After a 14-percent decline in 1981, labor productivity—measured by net industrial output per person employed—grew slightly in 1982-83 because total industrial employment dropped 6 percent because of the early retirement program and increased maternity leave. [redacted] 25X1

The industrial rebound was hindered, however, by the government's investment cuts of over 40 percent during 1978-82. The cutbacks particularly hampered natural resource exploration and further weakened the long-neglected transportation system. Polish economists, for example, attributed the leveling off of coal production in 1983 and the sharp declines in natural gas output in 1982-83 to insufficient exploration funds. A railroad official admitted in late 1982 that one-fourth of the country's railroad tracks and one-sixth of its rolling stock needed repairs for which there was a serious shortage of parts. State truck transportation also suffered from shortages of repair parts and poorly maintained roads. Because of these deficiencies, some plants were forced to sell their products at the factory gate or to curb output, according to Polish press reports [redacted] 25X1 25X1

As for agriculture, Warsaw used both threats and incentives to encourage private farmers—who produce 75 percent of output—to grow more crops, particularly grain, and to increase sales to the state.

Table 3
Poland: Economic Adjustment Measures and Their Impact, 1982-83

Target	Goal	Measures	Impact
		1982	
Industry	Increase or stabilize production of selected industries, especially raw materials and consumer goods.	Major sectors of the economy were "militarized" for example, workers faced harsh penalties for failing to work or being uncooperative. Tight central controls over 50 percent of industry in 1982 despite the decentralizing reforms.	Industrial production fell only 4 percent in 1982, compared with almost 13 percent in 1981.
		1983	
		Number of operational programs reduced (from 14 to six), but new "voluntary" government contract system maintained central controls; for example, enterprises were assured of inputs and hard currency if they committed their production to government hands.	
		Workweek extended to 46 hours in 1,800 enterprises specified by the Council of Ministers.	Industrial production increased 4 percent in 1983 compared with 1982.
		Workers in some plants required to give up to six months' notice of resignation; restrictions on pay increases imposed on workers who change jobs.	Undermined economic reform provisions.
		Job placement only through authorized employment agencies in industrialized areas; factories are practically obliged to hire those sent by the government.	
		Campaigns initiated to eliminate waste of raw materials, energy, and excess employment.	
		Tax incentives for industries producing quality goods.	
		Financial benefits for retired workers who return to the job, intended to lure back 550,000 workers who retired early.	
Agriculture	Decrease agricultural imports from the West.	Encouraged private farmers to sell to the state by increasing procurement prices and reaffirming support for private farming through a new provision in the Constitution. The regime also increased pressure on private farmers to sell to the state by linking the sale of farm inputs to their sales and threatening compulsory deliveries.	Farmers did not respond immediately; the regime had to import 3.5 million tons of grain in 1983. By December 1983 grain sales to the state were sufficient to satisfy demand. Livestock numbers, however, fell in 1982-83.
		Increased investment in the agricultural sector in 1983.	
Investment	Decrease government spending and imports.	Decreased investment outlays in 1982 with some increases in 1983 largely as part of economic reform.	Much Polish industrial equipment will become outdated in the next several years, decreasing competitiveness in Western markets. (The 1983 investment increase was spent primarily on maintenance, not replacement.)
	Decrease industrial investments in favor of the consumer.	In 1983, 30 percent of total outlays was directed to the food sector, another 30 percent to the housing industry.	
		1982	
Consumption	Reduce consumer demand.	Price increases of over 100 percent on food and consumer goods.	Effective for only a short time because the regime allowed enterprises to increase wages.
		Continued rationing of consumer goods.	Effective in distributing goods in short supply, but created a system of illegal coupon trade.

Table 3
Poland: Economic Adjustment Measures and Their Impact, 1982-83 (continued)

Target	Goal	Measures	Impact
		1982	
		Restrictions on consumer credits for newly married couples and farmers.	
		1983	
		Progressive taxation of incomes above 25,000 zloty monthly.	Measures reduced incentive to increase earnings and productivity.
		Uniform taxation of private craft, trade, and service industries which earn above 160,000 zloty annually.	
		Uniform taxation of all types of farms according to the quality of each hectare.	
		Increased taxation of summer homes, foreign travel, and car fees.	Discouraged people from working harder and saving more.
		Increased interest rates on personal loans.	
		Increased downpayment to reserve an apartment.	
		Increases of consumer prices restricted to 15 percent.	
		Increased gift and inheritance taxes.	
		Sales tax on some high-quality goods implemented, sales on other goods increased.	
		Sale of many consumer goods regulated by province.	
	Increase consumer supplies.	Attempts to increase food and consumer good production by means cited in the industry and agricultural sections.	Ineffective; food sales fell 13 percent in 1982; consumer goods, 24 percent from 1981 levels.
		Crackdown on black-market sales.	Effective in reducing the size of the black market in 1982; activity up again in 1983.
		Enterprises banned from selling to their own workers goods which are in great market demand.	Disincentive to increased productivity.
	Control excessive price increases.	Strict control over consumer price increases implemented by enterprises.	Restricted many enterprises from passing on increased costs as specified under the reform.
		Contract prices for supply and investment goods frozen.	
Imports	Decrease dependence on the West.	Domestic and CEMA substitutes sought for hard currency imports.	Some limited success in 1982-83 in finding substitutes.
Exports	Increase exports to West.	Devaluation of the zloty rate from 35 zloty per dollar in 1981 to 85 in 1982.	Polish goods still overpriced in light of poor quality.
		Attempt made to regain lost export markets by charging below-world-market prices.	
		Export-producing firms given priority claim on imports.	
		In 1983, some firms allowed to retain some of their hard currency earnings.	
Government	Reduce government spending.	In 1983, tight control imposed over expenditures.	Supported by most consumers because the measures have little effect on the average worker.
		Number of government employees reduced and line held on their wages.	
		Attempts made to reduce subsidies for enterprise production and consumer goods.	Subsidies were decreased in 1982 but increased in 1983, contributing to a rise in the inflation rate.

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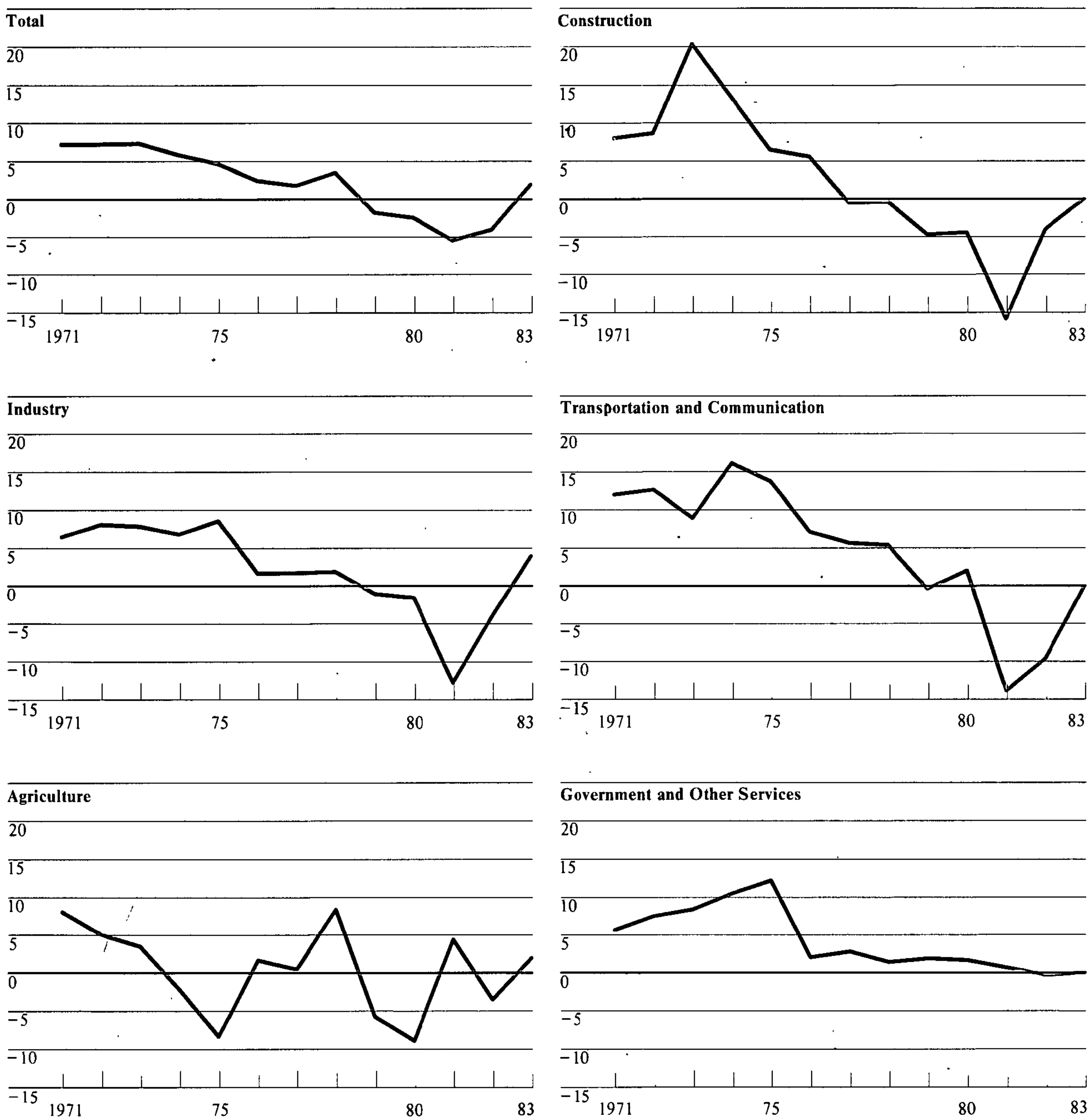
Figure 2
Poland: Average Annual Rates of Growth of GNP by Sector of Origin, 1971-83

Percent



Source: L. W. International Financial Research Inc., Research Porject on National Income in East Central Europe, Occassional Papers, No. 75-79. New York, New York, 1983.

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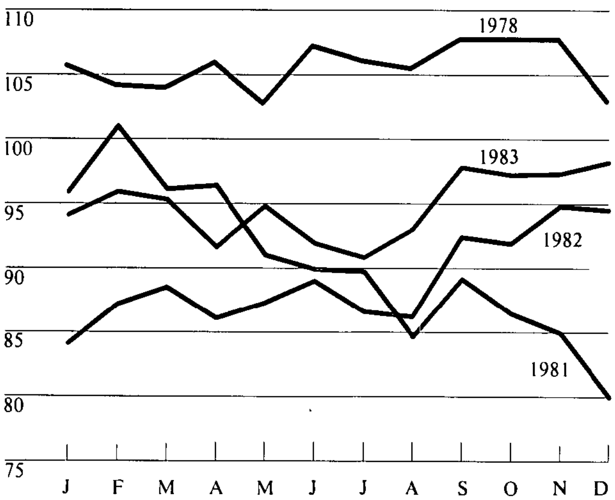
Figure 3
Poland: Monthly Industrial Production Index

Index: November 1976=100, seasonally adjusted



Source: Official Polish data.

[redacted]

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The regime threatened farmers that it would compel them to deliver products to the state, deployed military teams to the countryside to inspect farms, and linked the sale of inputs to government procurement. On the positive side, Warsaw liberalized inheritance and pension laws, increased the maximum permissible farm size and continued to grant credits and subsidies. In 1983 the regime encouraged grain sales to the state by raising grain procurement prices significantly. Warsaw also took steps to decrease the size of livestock herds to reduce the need for imported grain and protein meal. [redacted]

The regime succeeded in increasing grain production in 1982 and 1983, enabling Poland to reduce its hard currency imports of agricultural products. We estimate that total farm output dropped more than 4 percent in 1982 and then rebounded slightly in 1983, although it remained about 2.5 percent lower than in 1981. Warsaw had above average harvests of most crops mainly because of good weather in both years. The regime was able to buy 4.6 million tons of grain from farmers during the last six months of 1983, compared with only 3.1 million tons in the 12 months ending in June 1983. Livestock numbers decreased both years as a result of the reduced imports of grain and protein feed and regime efforts to reduce herd sizes. [redacted] 25X1

Austerity Program. These measures to boost production were complemented by the implementation of an austerity program to control the growth of demand. The goals of the 1982 austerity program were to cut investment by 10 percent and reduce the standard of living in order to shift resources toward the foreign sector. The government hiked prices of many foods and consumer goods an average of some 100 percent. Rationing was expanded to comprise 70 percent of food and 30 percent of nonfood items. Despite shortages in the domestic market, the regime continued to export food items such as meat and sugar for hard currency. [redacted] 25X1

In 1983 the government sought to allow a 2-percent increase in investment—the first scheduled increase since 1978—and moderated its consumer austerity programs. The authorities delayed and reduced scheduled retail price increases and maintained meat rations despite falling supplies. They also gave the production of consumer goods priority in the government contract system, permitted the operation of foreign-owned (Polonia) firms that produce primarily consumer goods, and reduced taxes on manufacturers of consumer goods. Despite considerable pressure from some economic planners, Jaruzelski refused to link future wage increases to productivity gains. The regime also liberalized benefits for pensioners and large families, reduced taxes on enterprise wage funds, and exempted overtime pay from income taxes. [redacted]

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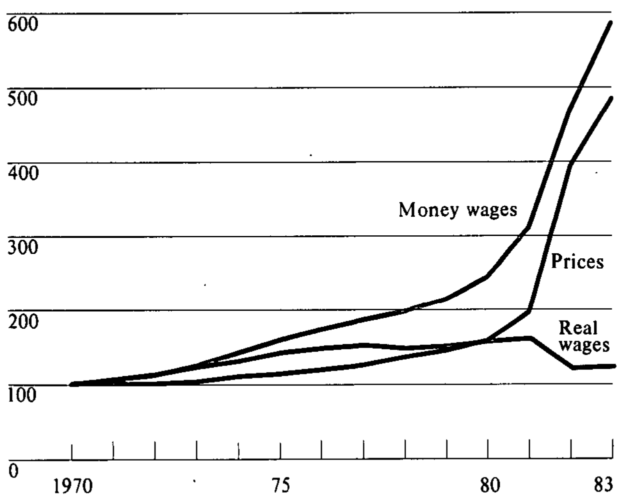
Although the martial law regime's austerity measures were limited—and, in some cases, fell short of what was intended—declines took place in consumption that were significant by Polish standards (see table 1). In 1982 consumer prices rose by 100 percent—with food prices rising 160 percent and consumer goods, 85 percent. Since the average nominal income increased

Figure 4
Poland: Growth of Money Wages, Prices, and Real Wages, 1970-83



Source: Official Polish data.

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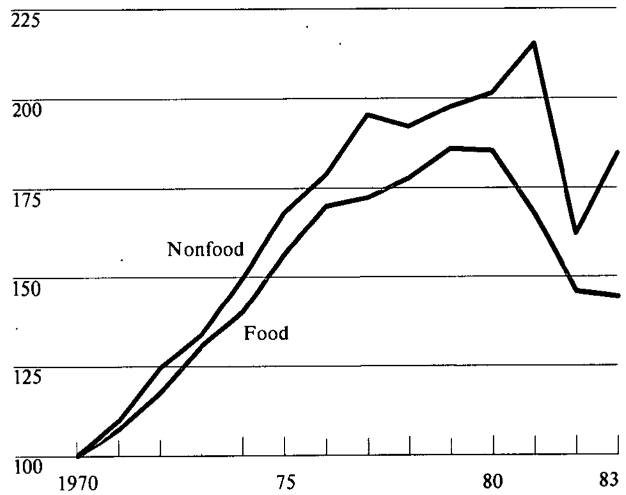
Figure 5
Poland: Sales of Consumer Goods in the Socialized Market, 1970-83



Source: Official Polish data.

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50 percent, real incomes declined by about 25 percent (see figure 4). Supplies of consumer goods in state markets fell 17 percent, with the sale of food dropping 13 percent and nonfood items, 24 percent (see figure 5). Despite shortages, queues for food and consumer goods eased because higher prices meant fewer people could pay. In addition, rationing and reduced hoarding assured a more equitable distribution. Although economic subsidies declined in 1982, the regime still ran a large budget deficit because consumer prices were still highly subsidized, low-income families were given increased benefits, and inefficient industrial enterprises continued to receive government financial support.

Warsaw's easing of its austerity program in 1983—primarily out of fear of worker protests—produced a small increase in the standard of living.[2] Real income increased by almost 2 percent, according to Polish statistics. The amount of food and consumer goods for sale in state markets increased 6 percent, and goods such as candy, liquor, cigarettes, soap, and detergent were no longer rationed. Meat supplies improved considerably in early 1983 because of increased slaughtering, although they then deteriorated rapidly. The regime diverted meat from export markets and imported additional quantities, bought on credit from China, to maintain the meat ration. Though still illegal, black-market operators increased their activity and filled the gaps for many affluent consumers as the regime increasingly ignored their activity.

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Polish officials admitted in late 1983 that retail price increases during the previous two years had not reduced the size of private holdings of cash and

[2] Regime officials readily admit, however, that workers continue to believe that their standard of living is being eroded. They argue that workers' perceptions are governed more by price than wage increases.

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savings.[3] According to the Polish press, these holdings were 10 percent higher in 1983 than the year before. These holdings reduced the incentives for workers to be more productive and have kept price hikes from balancing supply and demand. Warsaw has seemed reluctant, however, to introduce either a currency reform or a steeply progressive income tax to reduce the overhang.

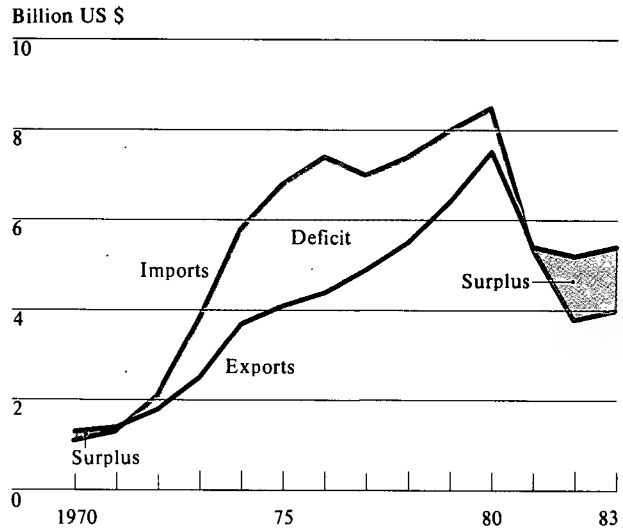
Improvements in Foreign Trade. Warsaw's foreign trade strategy was based on unrealistic assumptions about export prospects. The government counted on boosting exports 10 percent in 1982 and 12 percent in 1983, while keeping hard currency imports at 1981 levels. To achieve these goals Warsaw:

- Devalued the zloty by 60 percent against the dollar.
- Charged below world market prices.
- Gave export-producing firms priority claim on imports.
- Allowed some firms to retain part of their hard currency earnings.

Poland also aggressively tried to acquire substitutes for Western imported goods from domestic sources and its CEMA allies. The regime commanded factories deprived of Western imports to develop their own spare parts and sources of supply. Polish press articles indicate that Warsaw asked CEMA countries to deliver additional commodities and help with unfinished projects. The regime also tried to negotiate favorable trade agreements with its East European neighbors, primarily asking for the right to run trade deficits and to increase exports of machinery unsalable in the West.

The hard currency trade surpluses of over $1 billion in 1982 and in 1983, however, were the result of sharp import cuts forced by the severe drop in Western credits (see figure 6). During these two years, Poland obtained only $2.3 billion of an anticipated $3.5 billion in Western credits. The result was a decline in hard currency imports on a customs basis by 30 percent in 1982. Lacking credits, the regime had to arrange barter deals for most of its imports or pay cash, thereby reducing the amount of hard currency available for debt service.

Figure 6
Poland: Hard Currency Exports and Imports, 1970-83



Source: Official Polish Customs Data, current prices.

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Although raw material shortages became more common, Polish statistics show that the regime apparently had some success, especially in 1983, in shielding key industrial sectors from the import cutbacks. Polish economists estimate that imports of industrial materials from the West as a share of all hard currency imports increased from 53 percent in 1980 to 66 percent in 1982. Imports of Western machinery and equipment dropped by more than one-third in 1982 compared with 1981 and remained at that level in 1983, contributing to an increase in the average age of the industrial capital stock. Imports of agricultural

[3] Polish economists do not agree how best to estimate the inflationary overhang. One group, which calculated the overhang as 500 billion zloty at the end of 1982, derives this figure by taking the difference between the total amount of the population's money resources and an estimate of the transaction demand for money and target-oriented savings. Another group claims the overhang was 360 billion zloty at yearend 1982. Their estimate considers the cumulative compulsory savings in successive years, which is derived by taking the difference between the actual increase in money stock and the increase stemming from a natural propensity to save.

Not Much Help From the East

Warsaw continued to receive soft currency trade credits from the USSR in 1982-83, but was compelled to balance trade with most other CEMA countries. Polish trade deficits with the USSR amounted to the equivalent of $850 million in 1982 and $530 million in 1983—far lower than the $2.3 billion deficit in 1981. The USSR helped Poland by supplying 650,000 metric tons of grain in 1983 and delivering above-plan amounts of raw and semifinished materials such as cotton and various metals. The latter were paid for by Polish shipments to the USSR of 50 percent of the resulting output.

Warsaw had limited success in convincing CEMA to help complete unfinished investment projects. According to the Polish press:

- *The USSR is helping finish fertilizer, ball bearing, and textile plants, coke ovens at the Huta Katowice steelworks, metallurgical plants, and a rolled steel plant.*
- *The Soviets also are cooperating with Poland in building an atomic power station and the Kobryn-Brest-Warsaw gas pipeline.*
- *The Hungarians are helping Poland produce Jelcz buses.*
- *The Czechoslovaks have invested in light bulb and mining machinery factories and copper mines.*

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Past CEMA investment projects indicate that the Poles probably will have to pay for the aid by sending a certain percentage of output to the country that provided the help. The Poles apparently failed to enlist help from their CEMA allies for the 55 other investment projects for which it had sought assistance.

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goods and foodstuffs were cut in half during 1982-83, and, as a result, food supplies in state markets decreased by 14 percent in 1982 and another 1 percent in 1983.

The high levels of exports anticipated by government planners failed to materialize. Hard currency export receipts on a customs basis rose less than 10 percent in 1982-83 compared with 1981 levels—far short of the projected 22-percent increase and not nearly enough to cover originally planned imports and debt repayment obligations. Although the slide in industrial production was checked and the zloty was devalued, export performance in the West did not improve because of the poor quality of many Polish goods and unfavorable price changes in Western markets. The government also failed to give enterprises any significant financial incentives to produce for Western markets. Furthermore, although exports of coal and other raw materials to the West increased in 1983, growth in receipts was held back by slack world demand and Polish price cutting.

Poland had only limited success in finding domestic substitutes for Western imported goods or reorienting trade to CEMA (see box). The share of CEMA trade in total exports and imports increased but mainly because trade with the West declined. According to the Polish press, a group of Polish economists concluded that domestic or CEMA goods could substitute adequately for no more than 8 to 15 percent of Poland's imports from the West in 1982. Although the regime found some substitutes for food and agricultural imports and managed to obtain some supplies from CEMA and domestic sources for the machinery and chemical industries, the substitutes were often of lesser quality and sometimes hindered production. Some factories, for example, produced makeshift spare parts, but the machinery frequently worked less effectively. Most firms dependent on Western inputs produced at a lower level or simply closed. For example, the broiler industry, completely

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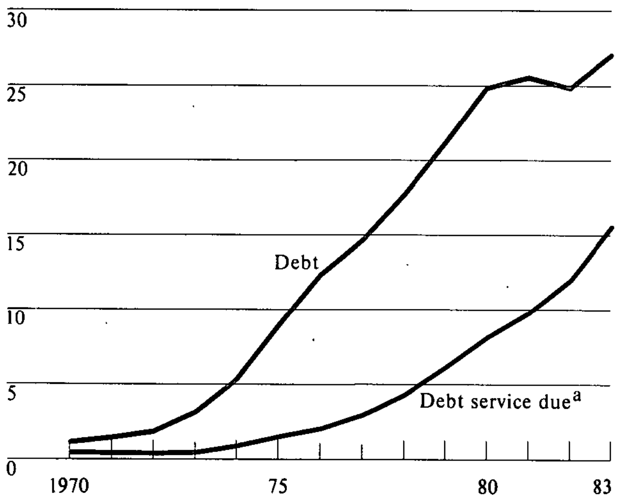
Figure 7
Poland: Debt and Debt Service Due, 1970-83

Billion US $



[a] Including arrearages.

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dependent on Western imports of feed, was almost totally wiped out when such imports plummeted in 1983 to 17 percent of the 1981 level.

Widening Financial Gap. Jaruzelski's adjustment policies only allowed Warsaw to cover a small part of its debt service obligations in 1982 and 1983. Warsaw enjoyed debt relief from the banks (see figure 7) in these two years on more favorable terms than in 1981 (see table 4) since the banks returned more than 50 percent of Poland's interest repayments in the form of short-term credits to finance Western imports for Polish export industries. In addition, the regime also slipped into a de facto moratorium to Western governments simply by not paying its obligations to official creditors after they had protested against martial law by refusing to reschedule.[4] At the same time, the regime rejected the advice of some economic officials to declare a moratorium on debt repayments, probably because—according to the Polish press—it realized that such an action would cut off new credits for a long time.[5] Warsaw sought to honor its payments to private banks both to increase the chance of acquiring new credits and to keep the banks from declaring Poland in default. 25X1

Adjustment measures and debt relief from banks were swamped by the enormity of Poland's debt service obligations and failure to raise sufficient credits. Lack of rescheduling agreements with Western and other governments put even greater amounts in arrears, while sources of financing decreased because of the drop in Western credits (table 5). Because $7 billion in principal and interest owed to official creditors was carried over from 1981 and 1982, Warsaw's financial requirement totaled over $14 billion in 1983. The regime covered only about $2 billion, leaving arrears of over $12 billion. 25X1

Polish Projections

Official Polish plans for 1984-85 indicate that Warsaw does not intend to pursue greater austerity over the next several years (see box for Polish statements on the country's financial and trade situation). Although the plans project increased trade surpluses during 1984-85, they state that Warsaw will allocate only $2-3 billion per year for debt repayments even though its financing requirement will be over $16 billion each year. National income is slated to reach the level of 1980 by 1986, and consumption and investment are expected to increase to 1981 levels. Large increases in exports are expected; imports are slated to grow almost as fast as exports and will be directed mainly to export sectors. Warsaw intends to seek further debt rescheduling agreements and new Western credits and will continue to seek assistance from its CEMA partners. 25X1 25X1 25X1

Domestic Economic Policies. The plans assert that the economy will grow by 3 to 4 percent annually over the next two years. Industrial production is slated to

[4] Because there were no negotiations among governments in 1982-83, virtually all debt payments in those two years were to Western bank creditors. Many bankers stopped calling for Western government rescheduling when they realized that any payments to governments probably would reduce the payments to bank creditors.

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Table 4
Rescheduling Agreements

Agreement	Agreement on Terms	Signature	Obligations	Debt Relief	Repayment Terms		Comments
					Interest Rate	Repayment Period	
Poland							
1981 Paris Club Agreement	March 1981	27 April 1981	90 percent of principal and interest on medium- and long-term loans in arrears of 1 May–December 1981.	$2.2 billion	Varies with creditor; generally 1 percent above domestic government borrowing rate.	January 1986–July 1989	Bilateral accord with the United States not signed because of $28 million arrears on unrescheduled payments due in 1981.
1981 Bank Agreement	August 1981	6 April 1982	95 percent of payments on medium- and long-term debt due 26 March-31 December 1981.	$2.3 billion	LIBOR plus 1.75 percent	December 1985–December 1988	1981 interest payments completed in March 1982.
1982 Bank Agreement	August 1982	7 November 1982	95 percent of principal on medium- and long-term debt due in 1982.	$2.2 billion	LIBOR plus 1.75 percent	September 1986–September 1989	Interest paid in three installments, November 1982, December 1982, and March 1983. Separate agreement provided that 50 percent of interest payments be re-lent in the form of six-month trade credits rolled over for three years at an interest rate of 1.5 percentage points over LIBOR.
1983 Bank Agreement	August 1983	November 1983 planned	95 percent of principal on medium- and long-term debt due in 1983.	$1.2 billion	LIBOR plus 1.875 percent	January 1988–July 1992	Principal repayment schedule is graduated 10 percent due in 1988 increasing 5 percent annually to reach 30 percent in 1992. Separate agreement provides for 65 percent of interest payments to be re-lent in the form of six-month trade credits, rolled over for five years at an interest rate of 1.75 percentage points over LIBOR.

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Table 5
Poland: Financing Requirement and Sources, 1982-84

Million US $

	1982	1983 [a]	1984 [b]
Financing requirement	**10,778**	**14,496**	**16,856**
Current account	−3,039	−1,787	−660
Trade account	358	1,085	1,400
Exports	4,974	5,402	6,400
Imports	4,616	4,317	5,000
Interest [c]	−3,799	−3,279	−2,560
Other invisibles, net (excluding interest)	402	407	500
Short-term debt repayments, net	−110	264	0
Medium- and long-term debt repayment due:	−7,061	−5,482	−4,045
Paris Club creditors	2,573	1,825	1,808
Banks	2,442 [d]	1,371 [d]	619
Other creditors	2,046	2,286	1,618
Arrearages from previous year	−573	−6,963	−12,151
Net credit extended	5	0	0
Sources of financing	**3,815**	**2,345**	NA
Credits	1,670	903	700
Debt relief	2,050 [e]	1,200	
Other	95	242	
Arrears/gap	**6,963**	**12,151**	NA

[a] Preliminary.
[b] CIA projection.
[c] Amounts are for interest due rather than interest paid. Because Poland has not paid all interest due, the figures for interest and the current account deficits overstate the hard currency outflows.
[d] Includes principal payments deferred until the following year under the bank rescheduling agreements for 1981 and 1982.
[e] Includes interest deferred until 1983 under the 1982 bank agreement.

Source: Polish Ministry of Finance, official Polish data.

[redacted]

rise by 4 to 5 percent each year, largely because of more efficient use of energy and raw materials, further implementation of reforms adopted in 1982, and large increases in worker productivity (beginning with a 10-percent gain in 1984). The regime hopes to boost productivity by providing increased incentives, such as more consumer goods. To increase agricultural output by a projected 3 percent annually, the government plans to raise farm procurement prices and give private farmers access to more supplies. It says it tends to increase sales of consumer supplies by about 7.5 percent annually, largely by boosting supplies of manufactured goods; per capita consumption of most quality foods such as meat, milk, and eggs is to grow only 1 to 1.5 percent annually. Nominal wages are slated to increase by 17 percent a year and prices by about 15 percent. Investment outlays will increase slightly, with emphasis on agriculture and on resuming work on one-third of the industrial investment projects frozen in 1981-82. [redacted] 25X1

Trade and Financial Policies. Warsaw projects hard currency trade surpluses of about $1.4 billion in 1984 and $1.8 billion in 1985, with exports rising over 11 percent annually and imports increasing more than 9 percent each year. Although coal exports are expected to remain at 1983 levels [redacted] exports of food products, primarily meat, are scheduled to increase 25 percent and exports of machinery, about 10 percent annually. At the same time, Warsaw is hoping that the USSR will continue to allow it to run a soft currency trade deficit and will agree to a rescheduling of debt due in 1986. [redacted] 25X1 25X1 25X1

Polish officials have said in press interviews that the regime will try to defer the bulk of its debt repayment obligations into the next decade, while securing new credits to finance imports. Furthermore, Warsaw will ask its private creditors for a multiyear rescheduling package on more favorable terms than the 1983 bank agreement, including more generous credit provisions. As in the past, Polish negotiators, we believe, will argue that new credits are necessary to finance imports of intermediate goods vital to Poland's export-producing industries. To boost its standing with Western creditors and obtain new sources of financing, the Poles will undoubtedly press again for readmission to the International Monetary Fund. [redacted] 25X1 25X1

Evaluation

Not only do these plans make no provision for covering all of Poland's debt obligation, they are based on an assumption—which we consider very shaky—that

Polish View of The Financial and Trade Situation

We want a long-term settlement of Poland's financial problems, but we cannot accept a solution that weakens our production potential or leads to a deterioration of the country's standard of living.

Deputy Premier Manfred Gorywoda at the 14th PZPR Central Committee Plenum, 19 November 1983

In the capitalist countries, the overcoming of a crisis begins with drastic budget cuts on social expenditures. We in Poland do not wish to follow this road nor can we do so.

General Wojciech Jaruzelski at the 14th PZPR Central Committee Plenum, 19 November 1983

Just as the "umbrella" theory proved futile so it is now commonly known that no one—be it a bank or government—will ever risk putting a major debtor in a state of default.

Aleksander Jung, Polish economic official, 20 November 1983

Let us remember that the sanctions imposed on Poland caused considerable economic losses, which must be taken into consideration when resolving the problem of debts.

Stanislaw Dlugosz, deputy chairman of the Planning Commission, 30 October 1983

For various reasons, most Poles have resented the export of Polish goods in the postwar period. While the average Englishman, German, or Japanese welcomes the presence of his country's goods on foreign markets, a Pole reconciles himself of exports only when this proves absolutely inevitable.

Henryk Chadzynski, economic journalist, Zycie Warszawy, *3 November 1983*

When at the end of the 1990s a half of the industrial plants in the world will be turning out products involving electronic components, Poland only will be able to sell some unprocessed raw materials, probably at a loss, some building services, which will face stiff competition from underdeveloped countries, and primitive products of the engineering industry, which no one else will find profitable to make any longer.

Stanislaw Stepien, Polish businessman, 13 November 1983

The technological gap is growing. We are at present seriously behind the average world level of technology so the competiveness of our products in world markets, incuding CEMA, is deteriorating. Reducing the gap requires an increase in investment outlays in the next few years.

General Wojciech Jaruzelski at the 14th PZPR CC Plenum, 19 November 1983

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Western creditors will provide generous debt relief. If the creditors fail to come through, Warsaw seems ready to risk default or continuation of the present situation vis-a-vis Western governments.

Even if they do maintain the good will of their creditors, the Poles will still have trouble meeting their own goals. Many of the problems that plagued the Polish economy in the 1970s have worsened in the 1980s. Economic planning has not become any more realistic, judging by such moves as the decision to complete the Katowice steel plant. Major systemic problems persist, despite the regime's verbal commitment to economic reforms. Most importantly, the authorities fear that severe consumer austerity measures would provoke political unrest. 25X1

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Likely Trends in Production, Consumption, and Investment. We believe the regime will have problems fulfilling the plan for industry. Output of the mining industries, according to some Polish economists, has reached its upper limit because of the lack of investment in new mines. Increased output in manufacturing industries will continue to depend heavily on more imports of raw materials and intermediate goods from the West. Moreover, the main factors that helped boost industrial production in 1982-83—a longer workweek and the return of many retirees to manufacturing enterprises—are one-time sources of improvement that could even disappear if many pensioners retire again because of limited incentives. Lack of adequate incentives also could hold down gains in labor productivity.

Warsaw's hopes for improved efficiencies from its reforms and conservation programs seem badly misplaced. Economic reforms have been steadily eroding since 1982, partly because the regime feels a need to maintain tight central controls, and few besides Jaruzelski and some of his close advisers favor reform. Many government officials resent the potential erosion of their power. Enterprise managers are not prepared to take responsibility for their actions, and most workers equate reform with higher prices and lower pay. The regime's conservation program also gives little promise of easing scarcities because enterprises still have no incentives to conserve and only limited funds have been allocated to the program. Much of the existing industrial structure uses excessive energy and raw materials and would require substantial capital outlays to revamp.

Judging by past broken promises, the regime probably will not increase investment in the agricultural sector enough to achieve higher levels of farm output. Investment in the sector last year was only slightly higher than in 1982, despite a government pledge to provide farmers a much larger percentage of the state investment budget. Crop output was helped significantly in 1982-83 by generally good weather—something the government cannot count on. Finally, increasing the size of livestock herds may prove difficult in the wake of the increased slaughtering in 1982-83.

Despite the need to hold the line on or reduce consumption, the regime shows no sign of changing its policy of allowing nominal incomes to grow more rapidly than consumer supplies. Continuation of this policy will only intensify inflationary pressures and make price hikes a less effective means of reducing demand. Moreover, the regime, to curry favor with the populace, could easily give in to pressures to lift further the lid on incomes. This could aggravate the imbalance between demand and supply in the consumer market.

Industrial investment also could increase more rapidly than projected in the next several years. Even though investment rose 4 percent more than planned in 1983—largely because under the economic reform industrial enterprises were given greater control over investment funds—the regime has not tightened controls. Moreover, the government's decision to resume work on some large, partially completed investment projects could, as in the past, boost investment more than anticipated. A large increase in unplanned industrial investment may cause central planners to divert funds from agriculture.

Continuing Problems With Foreign Trade. The government, in our view, will be hard pressed to achieve its ambitious targets for foreign trade, particularly because of obstacles to improvements in export performance:

- Meat exports could easily be held down by domestic production problems and constant pressure to divert planned meat exports to Polish consumers.

- Efforts to increase machinery exports will have to overcome the poor quality of Polish products and a widening technological gap between Poland and the West.[6]

- Exports of building services, which earned $673 million in 1982, also are likely to remain low in the next few years because many of Poland's traditional customers in the Middle East are restricting investments.

[6] Polish economists have said, for example, that 65 percent of machine tools currently in use in the country will be at least 10 to 15 years old in 1985.

- The coal industry probably will be able to meet its export goals but is unlikely to rise much above 1983 levels because of stagnating production.

Aside from financing problems, the Poles will also have difficulty, we believe, keeping down the rate of growth of Western imports because of their need to increase imports to fuel economic growth.[7] Resuming investment projects frozen in 1981 could easily lead to higher imports without commensurate export gains. Consumer pressure for improvements in the standard of living could prompt the regime to increase imports.

Poland will not gain much in terms of real resources or financial aid in its trade with CEMA over the next several years. Indeed the USSR, according to Polish press reports, probably will reduce the soft currency trade deficit that Poland will be allowed to run. Other CEMA countries are likely to demand that Poland run trade surpluses to pay back aid given in 1980 and 1981. They also are likely to extend only minimal assistance to the Poles in completing investment projects, and most will be reluctant to make substantial investment without guarantees of significant economic returns. Moreover, we believe that Poland has already exploited the available CEMA and domestic substitutes for imports from the West.[8]

Large Financial Gap Remains. Even if Warsaw achieves its projected trade surpluses, it will not have come very far toward covering its financial obligations. We estimate that this year Warsaw will be able to pay most of the interest due Western bankers only by leaving completely uncovered the more than $16 billion in arrears owed Western governments and other creditors. To cover debt maturing this year as 25X1 well as arrears, Poland needs highly concessionary rescheduling agreements with Western governments, favorable rescheduling terms from banks, and substantial new credits. The Poles, in our view, will try to convince their creditors that the alternative to such Western concessions is a Polish default.[9]

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Poland's policy of minimizing debt repayments—as long as its creditors continue to go along with this strategy—will take some pressure off the economy, 25X1 but will create even greater problems in the long term. As long as some interest is unpaid, both the debt and the interest payments required to service the debt will grow. For example, if Warsaw can pay only $1 billion in interest annually, the debt will increase to $32 billion by yearend 1985 and $40 billion by 1990. To prevent an increase in debt, the regime would have to generate trade surpluses equivalent to annual interest payments. This would require a significant boost in exports—which the Poles have not yet been able to do and which they claim depends heavily on increased imports—and a tough austerity program that the regime is especially reluctant to impose. Until Warsaw changes its economic priorities, Polish leaders will continue to view the servicing of its foreign debt as 25X1 only one—and not the most important—of its many economic problems. Moreover, a sustained improvement in Polish economic performance is not possible without measures and reforms to deal with some of the systemic and other factors that were the roots of the crisis.

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Implications for Political Stability

The government's continued refusal to implement draconian measures that could help resolve the balance-of-payments crisis is based on the justified fear that such actions would seriously endanger the

[7] We think the growth of Poland's GNP is closely associated with the growth rate of hard currency imports. Greater GNP growth requires progressively greater growth in hard currency imports. We estimate an average elasticity of imports to GNP of over 1.25 in the 1983-85 plan. If political pressures cause an increase in imports of consumption goods without compensating reductions elsewhere, an even more rapid increase in hard currency imports will result. A rebound in consumption levels to 1977-78 highs by 1985 without compensating cutbacks elsewhere would result in a hard currency imports/GNP elasticity of 2.

[8] According to unpublished CIA analysis, metals, machinery, light industry products, food, and agricultural goods, for which it is difficult to find substitutes in CEMA or in the domestic economy, now account for the bulk of hard currency imports. Continued successful substitution away from hard currency imports in other commodity categories cannot have much impact on overall hard currency imports, since even a 10-percent reduction in these other areas would yield only a 2-percent reduction overall.

[9] Debates are continuing within the Polish regime on ways to handle the debt policy, especially with government creditors. In recent 25X1 articles in the Polish press, the chairman of Bank Handlowy argued for continuing with the negotiation, while a deputy chairman of the Planning Commission advocated postponement of Polish payments into the next decade. 25X1

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country's fragile stability. The authorities clearly are seeking to buy time. They hope to deflate consumer expectations—through constant propaganda about the country's perilous economic situation—so that small increases in consumption will be enough to help preserve political tranquility and stimulate worker productivity.

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Although the regime's use of force and intimidation can maintain a superficial calm over the near term, its economic policies will not produce a more enduring political stability over the longer term. Most Poles do not believe regime statements, attribute economic shortcomings to government ineptitude and/or Soviet "exploitation," and are unwilling to make sacrifices as long as there are wide disparities in incomes and access to goods. Moreover, government success in maintaining a modicum of social peace could make the authorities overconfident and reduce their interest in solving systemic and management problems necessary to put the country on a sounder economic footing.

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Postponement of austerity measures may also make it more risky to implement them later in the decade. In the coming years the authorities will be confronted by a new generation of Polish workers, who are more alienated because their expectations were inflated during the Solidarity period and crushed by martial law. This generation might believe that it has less to lose by reacting violently to additional austerity measures.

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